that the availability of unbundled elements constrains ILECs' ability to price access at noncompetitive levels. AT&T 21, 44-46; CompTel 4-5, 16; Sprint 34-35, 49.

In one sense, the IXCs are correct: any rates for unbundled network elements will effectively establish a de facto price to which access rates inevitably must fall if ILECs hope to compete. The conclusion the IXCs draw from this observation, however – that access charges should be based on TSLRIC or TELRIC just because unbundled network elements are priced in this manner – is entirely mistaken. The Commission should not pursue foolish consistency by extending these unjustifiable methodologies to access rates. As discussed below, both approaches are inappropriate price-setting standards for unbundled elements, interconnection, universal service, access, or any other telecommunications service or product.

TSLRIC and TELRIC have utility only in determining whether certain rates are cross-subsidizing other rates in a multi-product firm;[31] they are entirely unsuitable for setting prices. Among their many flaws, these methodologies, as defined by the FCC and parties supporting it, intentionally fail to permit recovery of embedded costs; grossly understate actual forward-looking costs;[32] create profound disincentives to investment by ILECs and potential facilities-based competitors; and interfere with market forces by leaving no room for ILECs to adjust rates to respond to market conditions.[33] These shortcomings are aggravated in the access market because TSLRIC and TELRIC do not account for the fact that current access rates include over-allocations of costs to the interstate jurisdiction, but ILECs have no legal ability to recover such interstate-allocated costs through increased intrastate rates. *See, e.g.*, BA/NY 19-23; GTE 22-23;

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31 *See* Richard Schmalensee & William E. Taylor, "Economic Aspects of Access Reform: A Reply," attached to USTA Reply Comments.

32 This understatement results from several factors, including the failure to consider actual in-place technology and the assumption of unrealistically high output levels.

33 Moreover, the specific models advanced by AT&T and MCI have been discredited due to their irrational assumptions and inadequate recognition of shared and common costs. *See, e.g.*, Cal. Pub. Util. Comm'n Decision 96-10-066, R.95-01-020, I.95-01-021 (issued Oct. 25, 1996).

SNET 25-26; USTA 13-16; Schmalensee & Taylor.[34] For these reasons, acceding to the IXCs' pricing demands would only exacerbate the already grave cost recovery concerns engendered by the *First Interconnection Order*, the numerous state arbitration decisions purporting to adopt a TELRIC/TSLRIC methodology notwithstanding the Eight Circuit's stay,[35] and the Joint Board's *Recommended Decision*.

4. Failure to permit recovery of embedded costs and the actual, current costs of operating the network would work an unconstitutional taking.

As discussed above, the IXCs' efforts to minimize or ignore the embedded cost recovery problem are without factual or legal basis. These costs exist, they were prudently incurred, and they are substantial. Perhaps conceding the weakness of their "see no evil" approach, the IXCs suggest that there is no legal requirement to afford ILECs the opportunity to recover their embedded costs in any event. *See* AT&T 21-22; MCI 74; TRA 32-33. This assertion, too, misstates the law. Failure to provide a reasonable opportunity for cost recovery would be an incontrovertible and unconstitutional taking of ILEC property.[36]

As Professors Sidak and Spulber exhaustively explained in their affidavit and confirm in their reply affidavit, attached to USTA's comments and replies, respectively, the embedded cost recovery problem results directly from the longstanding regulatory compact between the FCC, the states, and ILECs. Under that compact, ILECs agreed to uneconomic depreciation lives based on assurances that, over time, they would have the opportunity to recover their historical costs. That opportunity is a property right every bit as

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[34] In addition, the Commission is mistaken in suggesting that these pricing methodologies will produce rates similar to those that would prevail in a fully competitive market. Firms in competitive markets set prices based on numerous factors, including but by no means limited to, forward-looking economic costs. In any industry, past investments (as well as all shared and common costs) must be recovered or the firm cannot survive. In addition, in unregulated markets, firms consider such factors as demand elasticities, product differentiation, and technology in establishing prices. *See* GTE 21-22; Southwestern Bell 47-48.

[35] As GTE pointed out in its opening comments, numerous states have employed methodologies that do not even produce TELRIC rates as defined in the FCC's rules. GTE 22 n.38.

[36] AT&T's suggestion that the constitutional problem can be "solved" by permitting ILECs to file waivers is absurd. Responsible decisionmaking requires that policies which virtually guarantee inadequate

real as a house located in the path of a new freeway. Destroying that right in order to pave the way for competition is, undeniably, a taking. *See, e.g.,* Citizens 44-47; PacTel 44-46; TDS 12-16; USTA 68-72; U S WEST 6-10. To avoid this outcome, the Commission must establish a competitively neutral mechanism that affords ILECs the opportunity to recover both their embedded costs and any other interstate-allocated costs that result from regulatory policies, and for which market-based recovery is not feasible, as discussed in Section III.B, below.[37]

C. The Commission Cannot Continue To Duck Resolution of the Cost Recovery Problem by Shifting the Issue to Other Dockets or the States.

The bucks implicated in the cost recovery problem must stop here. The *Alice in Wonderland* theory of the *First Interconnection Order* ("cost" means what the FCC says it means, and nothing more) was somewhat tempered by the promise that cost recovery issues would be dealt with in the universal service and access reform dockets. Notwithstanding this commitment, however, the Joint Board's *Recommended Decision* only exacerbated ILEC cost recovery concerns, and the IXCs are doing their best to assure that access reform hews to the same economically indefensible course taken in the first two "trilogy" proceedings. The Commission must resist the IXCs' entreaties and firmly and fairly address cost recovery in this docket, as well as other dockets in the "trilogy."

There is nowhere else to turn. While separations reform eventually may reallocate some costs to the states, ILECs must be given the chance in the interim to recover all costs that currently are considered interstate according to FCC rules.[38] The Commission cannot reduce the ILECs' interstate revenue requirement by regulatory fiat; it must follow the procedures set forth in Section 410 of the Act. Nor may

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cost recovery should be avoided from the outset.

[37] The Commission must also deregulate ILEC depreciation practices on a going forward basis in order to avoid exacerbating the depreciation reserve deficiency.

[38] If costs are shifted to the states through separations reform, the same cost recovery issues would exist there.

the Commission indirectly accomplish the same thing by presuming that ILECs will be able to raise local rates or intrastate access charges to recover the interstate shortfall. Such a presumption would be unlawful, since these costs have been allocated to the interstate jurisdiction.

The Commission has no lawful recourse but to make recovery of embedded and other regulatory policy costs a key element of access reform. GTE's specific recommendations in this regard are detailed below.

III. GTE'S PLAN WILL PRODUCE RATIONAL AND EFFICIENT PRICES.

A. There Is Overwhelming Support for Eliminating SLC Caps and Deaveraging the SLC.

The consensus in all sectors of the telecommunications industry is that the most efficient method for recovering the cost of local loops is through a flat-rate SLC billed to end users. Many also agree that the SLC be geographically deaveraged. Commenters widely concurred that, because local loop costs are not traffic-sensitive, usage-based recovery mechanisms for local loop costs are inefficient. *See e.g.* AT&T 51-54; Ameritech 9; BellSouth 68-69; CA & CPUC 3; CompTel 29; MCI 76-77; TCI 9-10; Time Warner 4-5. A cost-recovery mechanism that assesses costs directly on end users is administratively efficient, avoids "dial around" problems arising from billing intermediary IXCs rather than customers, and is rational because it assesses the costs on the cost-causers. AT&T 51-54; CompTel 29; Cincinnati Bell 9. Therefore, the Commission should eliminate SLC caps for all customers, not just second residential lines and multi-line businesses, except where the Commission determines that such direct recovery should be subsidized by another explicit external source. *See* GTE 24. Geographically deaveraging SLCs will promote efficient cost recovery since the cost of a loop varies by geographic location. *See, e.g.* Sprint 17; Illinois CC 10-12; WorldCom 34; Ameritech 12-13.

There is no basis for granting requests for *lower* SLC caps. AARP, for example, has argued that the SLC cap should be slashed to $1.80 per line and dropped even further for second residential lines.[39] *See* AARP 14-16; *see also* NARUC 12. A decrease in the SLC would simply create a larger shortfall and require an increased payment from the universal service fund. Removing or relaxing the caps, in contrast, will allow prices to move toward their proper market levels while preserving universal service protections.

Some commenters urged that caps be removed on all lines, *see e.g.*, AT&T 51-52; others supported eliminating the cap for only second residential lines and multi-line businesses, Ad Hoc 12-13; Ameritech 11-12; USTA 56; and others merely supported *raising* the cap for most services. CA & CPUC 3. The Commission should lift the SLC cap for *all* customers. There is no good policy reason for treating the first line ordered by a residential customer any differently from a second line. Furthermore, those commenters who oppose raising SLCs on primary lines make no attempt to suggest how ILECs could solve the administrative nightmare of distinguishing between primary and nonprimary lines. GTE also agrees with USTA's argument that the cap on multi-line business customers should be eliminated in order to ensure that pricing is competitive and flexible. USTA 56.

Moreover, ILECs should be allowed to recover the interstate-allocated costs of local loops directly from carriers using the ILEC's loops as unbundled elements to provide services to the customer. As long as the separations treatment for common lines remains unchanged and the FCC fails to provide for full interstate cost recovery, it is appropriate for ILECs to charge the SLC to purchasers of unbundled loops. In this way, even if a competitor "wins" a customer using an ILECs' local loop, the ILEC would be permitted to recover its costs and avoid the pricing "death spiral" described in Section I.D., *supra*. *See* U S WEST 54-55.

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[39] AARP's conclusions are based on the assumption that all local exchange services should be priced based on TELRIC. In reality, no company could price all of its services based on TELRIC and expect to stay in business.

If the Commission determines that end user rates may not be affordable when SLC caps are eliminated and finds it necessary to retain SLC caps in certain instances during a transition period, it should nonetheless permit ILECs to recover residual costs through a separate mechanism.[40] GTE has proposed that, where SLC caps prevent an ILEC from recovering its loop costs, the Commission should allow the ILEC to recover the uncovered portion of their common line costs through the new universal service mechanism. In this manner, the common line costs covered by IXCs would be distributed among all IXCs according to their universal service contributions instead of using the CCL's inefficient and disfavored usage-based approach. Because universal service funding is based on contributions from all telecommunications carriers, recovery through this mechanism is competitively neutral and will not distort consumer choices.

A less satisfactory third choice would be recovery of residual common line costs through a regulatory policy cost recovery mechanism.[41] This mechanism would operate in a competitively neutral manner, consistent with the recommendations of the Council of Economic Advisors, and would be assessed on a bulk-billed basis to all telecommunications carriers that purchase from ILECs interstate switched access and transport services and network facilities used to provide interstate services. The Commission should be aware, however, that this proposal would not insulate consumers from cost increases because these flat-rated charges would likely be passed on by the IXCs. Furthermore, this

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[40] By placing an artificial cap on the SLC, the Commission would keep prices low by denying ILECs the ability to recover the full cost of common lines. Any supplementary recovery mechanism, then, should allow ILECs to recover in full their actual costs of providing the local loop.

[41] Other commenters have proposed complicated hybrid cost recovery mechanisms, assessing per-line or bulk billing charges on IXC intermediaries rather than on the end users. MCI, for example, has proposed that IXCs pay a flat rate per presubscribed line, coupled with a mechanism assessing a per-minute charge on "dial-around" calls based on TELRIC principles. MCI 76. Such proposals are needlessly complicated and rely on a usage-based assessment that has been roundly rejected as incompatible with the nature of loop costs. *See* this Section, *supra.* Additionally, GTE agrees with those IXCs that oppose the proposed bulk-billing mechanism because recovery can be readily avoided by placing "dial-around" calls. C&W 10; LCI 20-24; Sprint 10-16.

mechanism would either encourage IXCs to utilize alternative access providers who do not have to impose such a charge, or enable those competitors to reap the benefits of the artificially high ILEC pricing umbrella.

B. TIC Reformation Is Essential.

GTE, along with the overwhelming majority of commenters, agrees with the Commission's position in the *NPRM* that the TIC must be reformed immediately.[42] The TIC is an outdated conglomeration of misassigned costs, which should be replaced in a timely manner with a more direct methodology for providing compensation for actual costs incurred. In its comments, GTE articulated its support for a cost recovery mechanism that reassigns misallocated costs contained in the TIC to the appropriate rate elements and allows recovery of costs misassigned to the interstate jurisdiction through a regulatory policy recovery mechanism, pending any modification in the separations rules.

Other commenters agreed with the basics of this approach. *See, e.g.*, Ameritech 20-23; BA/NY 36-38; BellSouth 74-81; Citizens 31-33; NECA 4-5; PacTel 71-72; SNET 39; TDS 22-24; USTA 58-66; U S WEST 64. Reassigning identifiable transport costs to the proper rate elements would apply charges on a more cost-causative basis. BA/NYNEX 36-38. Following these reallocations, the FCC must allow ILECs flexibility to reprice the affected services to permit full cost recovery.

There is substantial concurrence among the commenters as to which transport-related element costs should be reassigned. Such costs include: tandem switching costs, SS7/signal transfer point costs allocated to tandem switching, host remote links and analog end office trunk ports. *See* GTE 36; USTA

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[42] *See NPRM* ¶ 96-98. While the Commission acknowledged that it was responding to the CompTel v. FCC remand, BA/NYNEX correctly note that the *CompTel* decision does not require the elimination or reduction of the TIC (as suggested by Time Warner at 12-15), but instead requires more justification on how the rate is derived. BA/NYNEX 36-38.

58-66; U S WEST 64-71.[43] In addition, tandem-switched transport should be redefined by eliminating the minute-of-use ("MOU") option for serving wire center-to-tandem connections (since this accurately reflects the dedicated nature of this link), pricing tandem-switched transport to include all multiplexing costs, and permitting ILECs to set rates for tandem-switched transport based on company-specific MOUs as opposed to an arbitrary 9,000 MOU proxy.[44]

Commenting parties agree that, after reassignment of these identifiable costs to the appropriate cost centers, the costs that remain in the TIC are misallocated to the interstate jurisdiction. Ameritech 20-23; Citizens 31-33; Florida PSC 6; NECA 4-5; PacTel 71-72; USTA 58-66; U S WEST 64. Such local costs include central office maintenance expense, interexchange trunk investment, and interexchange cable and wire investment. PacTel 71-72. A consensus exists that no phase-out of the TIC should occur without concurrent separations reform and, until such reform occurs, an alternative mechanism must be established to enable LECs to recover these costs in a more appropriate manner. Cincinnati Bell 10-11; NECA 4-5; USTA 58-66; U S WEST 62-63, 72. While agreeing that the creation of some mechanism is essential, the nature of the proposed mechanism varied among commenters.[45] In its comments, GTE has articulated a proposal to remove these costs from the TIC and permit recovery through a regulatory policy recovery mechanism which distributes charges among all telecommunications carriers. GTE 38-39, 41-44. This regulatory policy cost recovery charge would be reduced, as appropriate, upon conclusion of the required separations reform.

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[43] While GTE agrees that ILECs should provide cost support information to quantify misallocated costs, there is no valid reason for exhaustive and detailed cost reports as urged by TCG. *See* TCG 31-32.

[44] NECA agrees that MOU calculations should more accurately reflect low usage in rural areas. NECA 8.

[45] NECA, for example, suggested that residual TIC costs should be recovered through a per minute charge or a bulk-billing arrangement, until separations reform is completed. *See* NECA 8-9; *see also* TDS 22-24.

GTE strenuously opposes simply eliminating the TIC, either altogether or just on the terminating end, and further disagrees that TSLRIC pricing will "solve" the TIC problem. *See* BellSouth 75; Cincinnati Bell 10-11; Citizens 31-33; SCA 34-37; GTE 36; NECA 4-5; PacTel 71-72; RTC 10-11; Southwestern Bell 9-10; TDS 22-24; USTA 58-59; U S WEST 63-64; Western 22. The essential question in assessing proposals to reform the TIC is whether ILECs are permitted to recover their costs. Any reform that does not permit ILECs to recover actual costs formerly contained in the TIC would (1) violate the Act's principle (and constitutional requirement) of allowing recovery of actual costs, (2) be unfair to ILECs, and (3) distort the market and lead to uneconomic decisionmaking and inefficiencies. Those commenters urging the Commission to eliminate the TIC without making provisions for recovery of current TIC costs, LCI 27-28, ignore the fact that those costs are identifiable and real. BellSouth 75.[46]

In the same way that SLC charges should apply regardless of the purchaser (*see* Section III.A., *supra*), the costs allocated to transport elements should be recovered from all purchasers of those elements (including all IXCs, resellers and purchasers of unbundled network elements). Southwestern Bell 50-52. The Commission must allow local exchange carriers ("LECs") to establish rates that recover all interstate-allocated costs, including embedded costs. BA/NYNEX 19-23; BellSouth 42-43; USTA 13-16. Accordingly, the Commission should reject proposals that permit ILECs to recover only a portion of embedded costs, or that do not allow cost recovery from all users of LEC facilities. *See, e.g.*, TCI 20.[47]

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[46] Sprint's proposal (using universal service funds and "productivity adjustments" to reduce and phase out the TIC) similarly ignores the actual, identifiable costs within the TIC that ILECs should be allowed to reassign and recover. Sprint 28-30.

[47] *See also* WorldCom 59-62; 62-72 (permitting ILECs to recover a portion of embedded costs only from their own end-user customers); Sprint 28-30 (prohibiting ILECs from imposing the TIC when an IXC uses an alternative access vendor for transport); Time Warner 12-15 (exempting CAPs from paying any residual TIC costs).

C. The Productivity Factor Must Be Based on Achievable ILEC Productivity, not Arbitrarily Set to Produce a Pre-Ordained Result.

The Commission should not yield to IXCs' efforts to manipulate the productivity factor to use revenue-based methodologies to arbitrarily drive down prices. GTE 57-58. Rather, as GTE explained in its comments, the Commission should adopt a productivity factor methodology that has as its base the ILECs' actual achieved productivity gains – total factor productivity ("TFP"). Specifically, GTE continues to support use of the simplified TFP methodology,[48] as performed by Christensen Associates ("Christensen"),[49] which uses publicly available data and produces an accurate estimation of ILEC productivity.[50]

As outlined in the attached affidavit of Dr. Gregory M. Duncan, the goal of the price cap formula is to reflect changes that could be expected in a competitive market experiencing technological change.[51] Productivity estimates advocated by parties such as AT&T and MCI would utterly fail to achieve this goal. Indeed, their proposals are replete with errors and erroneous assumptions,[52] and blatantly seek to use the productivity factor as an arbitrary tool to force down prices by selecting manifestly unattainable productivity levels.[53]

There are simply no recent market changes which indicate that LECs could realize such high productivity. To promote accuracy, the productivity factor should be optimally forecasted so that it will

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48 In the First Report and Order, the Commission tentatively concluded that a TFP methodology should be adopted. Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, 9027 (1995) ("*Price Cap Order*").

49 *See* USTA's Comments Attachment A, CC Docket No. 94-1 (Dec. 18, 1995).

50 The use of Christensen's TFP methodology was widely supported by commenters in this proceeding. Ameritech 44; Southwestern Bell 32-34; BellSouth 50-51; SNET 28-31; USTA 19-22; U S WEST 47-48.

51 Affidavit of Gregory M. Duncan at 3-4 (App. B) ("Duncan Affidavit").

52 *See* AT&T 69-71 and MCI 24-28, referencing studies submitted in their comments in CC Docket No. 94-1 (Dec. 18, 1995).

53 *See, e.g.,* Cable & Wireless 28-29 (proposing an annual 20% increase in the X factor). Other commenters simply urged the Commission to increase the X factor without providing specific details or

reflect recent market changes that will tend to depress productivity, including: (1) the impact of the regulatory policy cost recovery mechanism (which would entail eliminating both revenues and MOUs from the TFP calculation); (2) the change from usage-based to flat-rated charges for certain rate elements (*e.g.*, CCL and line ports); and (3) the increasingly competitive and risky nature of the telecommunications business. GTE 58. Recent figures demonstrate that the Commission should expect reduced revenue levels and lower productivity growth compared to historic trends.[54]

Moreover, proposals to use the productivity factor to achieve arbitrary rate reductions are inconsistent with existing Commission policy that the productivity factor should be a reasonable estimate of anticipated productivity. In a rulemaking to consider adjusting the productivity factor, the Commission stated that, in considering any alternative to the method it has previously selected for calculating the X factor, it would consider factors such as "economic validity," "accuracy of result, simplicity of administration, public availability of data, and auditability of data."[55] As Dr. Duncan explains, MCI wants to use the productivity factor as a lever to drive prices down rapidly rather than relying upon the market forces envisioned by Congress. This approach will fail, as Dr. Duncan notes, "[f]or the market to work, the price must stay up long enough for new firms to enter . . . and to engage in the competition that will drive the price down."[56] Only marketplace mechanisms can efficiently lead to lower access prices.[57]

Finally, the American Petroleum Institute's argument[58] that the Commission should calculate the productivity factor based only on interstate data should be rejected.[59] As Dr. Duncan states, it is

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support. *See* Ad Hoc 69-70; ACTA 20-21; NCTA 21-23.

54 *See* USTA, Att. 5, where Christensen estimates the potential decrease in productivity that will result from increased competitive losses and from the migration to flat-rate, as opposed to MOU, charges.

55 Price Cap Performance Review for Local Exchange Carriers (Fourth Further Notice Of Proposed Rulemaking), 10 FCC Rcd 13659, 13671 (1995).

56 Duncan Affidavit at 7.

57 *Id.*

58 This argument has been made previously by AT&T, Ad Hoc, MCI and others in response to the Fourth Further Notice of Proposed Rulemaking in CC Docket No. 94-1.

impossible to define separate total factor productivities.[60] Further, as GTE noted previously,[61] a properly constructed productivity offset reflects the entire range of diverse factors that cause changes in the unit cost of production for the ILECs, and measures changes in the overall efficiency of production. Interstate-only measurements are inconsistent with the economics of price caps because they are confined to only particular inputs or outputs. Further, there is no economically meaningful method of separating production between inter- and intrastate unless the technology of the industry is separable – a condition that does not apply to telecommunications. That is, separate factors for interstate and intrastate services make sense only if the provision of service in one jurisdiction is independent of the provision of service in the other. In reality, efficient operation in the telecommunications industry requires common facilities and shared resources. Accordingly, use of a factor that considers only interstate data (which are the product of arbitrary separations rules with no basis in actual production) is wholly illogical.

D. GTE's Price Cap Basket Structure Will Increase Competitive Pricing While Protecting Access Customers.

In its initial comments, GTE proposed immediately reforming the outmoded price cap basket structure to permit some pricing flexibility as competition increases, while providing ample protections to access customers. Under GTE's proposed structure, the current unwieldy and limiting array of baskets and service categories would be replaced by a single basket with three subcategories, containing only those network services that currently are not fully competitive.[62] In addition, the Commission should permit

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59 The Commission previously tentatively concluded that a "total company" approach is more appropriate than an interstate-only approach. *See Price Cap Order*, ¶ 159. The Commission based this conclusion, in part, on the fact that production functions differ for interstate and intrastate services in ways that can not be readily measured and separated, and that both services are largely provided over common facilities. It chose not to "attempt to construct an interstate factor based on regulatory accounting and other regulatory requirements that may not fully reflect economic costs." *Id.*

60 Duncan Affidavit at 5.

61 *See* Comments of GTE Corp., CC Docket No. 94-1, 21-22 (Jan. 11, 1996) (App. F).

62 Specifically, GTE proposes combining all services for which price cap regulation may still be warranted into one basket called "network services," containing three service categories (tandem switching

the establishment of geographic zones for the Tandem Switching and Transport and Local Switching service categories. GTE 49, 56-57. This new structure preserves much of the old system's controls (e.g. limiting the ability to raise overall prices by the PCI), but permits several necessary modifications in an administratively simple format.[63]

A number of commenters supported immediately reforming the price cap basket structure, although their specific proposals varied slightly from GTE's. BA/NYNEX 64-65; PacTel 20; BellSouth 31-32; Southwestern Bell 32-34. For example, USTA, along with numerous other parties, argued that ILECs should be eligible for a simplified price cap basket and band structure upon satisfying USTA's proposed Phase 1 trigger, the existence of an interconnection agreement or Statement of Generally Available Terms. USTA 25. This condition should be satisfied for all ILECs in most states by the time access reform becomes effective. Any services remaining in the baskets should at least be removed from price cap regulation as soon as the conditions for forbearance are met. USTA 50-54.

In contrast, several commenters urged the Commission to revise the existing complicated and obsolete price cap structure only after substantial competition is present. *See, e.g.*, AT&T 85. These commenters have failed to demonstrate that maintaining the existing structure of four baskets and multiple service categories, subcategories and zones is necessary to ensure rational pricing of access service. GTE's proposed reforms satisfy the concern raised by these commenters – that sufficient regulations remain in place during the transition to full competition to ensure that access rates are reasonable.[64] As Dr. Salinger observes, sufficient safeguards can be incorporated in the price cap structure, such as a constraint on raising prices in any one given zone, as proposed by GTE's 10% upper pricing limit, even if

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and transport, local switching and database services).

[63] For a fuller explanation of GTE's position on price cap reform, see the attached comments and replies GTE filed in CC Docket No. 94-1, which it includes in this record for Commission consideration (Apps. E-H).

[64] Affidavit of Michael A. Salinger at 15 (App. D) ("Salinger Affidavit").

unbundled elements are not available in a specific market.[65] MCI's claim that price cap flexibility will lead to selective price decreases rather than true access competition is speculative and absurd. Far from creating opportunities for unreasonable discrimination, simplification of price cap structures will promote pricing that is more responsive to customer needs. As Dr. Salinger explains, the availability of unbundled elements and price caps comprise sufficient safeguards to prevent unreasonable access pricing.

E. Certain Proposals Fail to Provide a Comprehensive Approach to Access Reform by Failing to Properly Balance Competition and Cost Recovery Goals.

The *NPRM* suggests that some combination of both the prescriptive and market-based approaches may be appropriate. A number of different proposals along these lines have been made formally in the comments and informally elsewhere. Each of these proposals fall short by not providing a comprehensive approach in the context of the "trilogy" proceedings, and thus fail to meet the twin goals of promoting competition and cost recovery.

As an example, one informal plan is as follows. First, the Commission would mandate reductions in switching-related elements to TSLRIC or some prescribed level, such as $0.01 per minute. Second, additional offsetting reductions would be made to access prices equal to the interstate portion of revenues received from the new universal service mechanism. Third, ILECs would be allowed to recover the residual (i.e., the difference between current revenue levels and revenue generated from new switching rates and the universal service fund) based on a flat-rated charge assessed per presubscribed line. Theoretically, this could permit an ILEC to recover their costs after regulatory action to reform access. However, the residual charge, and its inherent costs, would not be recovered if a competitor serves the end user using ILEC unbundled elements. Even though the costs would persist, the means of recovery would not. This proposal clearly illustrates several of the problems noted throughout GTE's comments.

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65 *Id.* at 7.

1. *Failure to recover actual costs.* Although this proposal incorporates some flexible pricing principles and admits cost recovery must be accommodated, it continues to ignore that any access reform plan must allow ILECs to recover their actual costs incurred in operating their networks. Eliminating the residual charge when a competitor serves the end user using the ILEC facilities, without dealing with the remaining costs, leaves the ILEC in the untenable position, as discussed previously, of having to recover remaining network costs from fewer and fewer customers. Not only is the ensuing "death spiral" of increased prices and lost customers damaging to ILEC customers, it is also unfair and economically unsound for new entrants that are using ILEC network facilities to avoid paying their fair share of these costs.[66]

2. *Continuation of illegal subsidies.* The residual pricing mechanism, because it fails to allow for efficient pricing and reassignment of costs based on cost-causation principles, would perpetuate the subsidies inherent in the existing access charge structure.[67]

3. *Distortion of market pricing.* As detailed in Section V.B, *infra*, forcing prices to some artificial level, such as prescribing switching rates at $0.01 or setting rates at TSLRIC, would produce inefficient results, distort competitive markets, and deter the development of true competition.

4. *Leads to irrational pricing.* By failing to adopt other access reforms, such as economic common line cost recovery or refusing to permit flexible pricing, such as geographic deaveraging or volume and term discounts, the hypothetical does not make sufficient movement toward rational pricing. Without rational pricing, competition cannot develop without distortions that harm consumers and competitors.

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[66] A portion of the costs associated with unbundled loops used by a new entrant will continue to be allocated to the interstate jurisdiction under the existing separations rules in a manner identical to those of other "presubscribed" loops. Thus, the Commission must permit sufficient recovery of interstate allocated costs, irrespective of how unbundled element prices are set through the negotiation process and/or state arbitration proceedings.

[67] A further refinement of the proposal, such as charging all common line costs through SLCs and reassigning TIC costs to more appropriate rate elements as GTE's plan would do, can solve a number of

5. Recovery of costs in anticompetitive manner. A charge assessed only on IXCs on a presubscribed line basis fails to charge costs to all network users on a fair basis. GTE has already demonstrated how a presubscribed line approach is burdensome and permits evasion through dial around traffic. It also forces the ILEC to recover its costs through a charge levied only on one class of customers, IXCs, which is discriminatory, disadvantages ILECs in the market, and requires IXCs to subsidize users of unbundled elements.[68]

For these reasons, the above-described mixture of prescriptive and market-based approaches can cause much damage to competition and consumers by failing to allow efficient pricing and weighting policies, such as promoting low prices, too heavily, and others, such as adequate cost recovery, too lightly. GTE believes that a more market-oriented solution, such as its proposal, better solves the dual problems of efficient pricing and fair cost recovery.

IV. CURRENT MARKET CONDITIONS REQUIRE THAT ILECS IMMEDIATELY BE GRANTED THE FLEXIBILITY TO PRICE EFFICIENTLY AND LAY THE GROUNDWORK FOR FULL COMPETITION.

A. The Current State of Market Development is Sufficient to Justify Substantial Deregulation of Access Pricing.

1. The existence of unbundled elements will drive down the price of access promptly.

As GTE's comments noted, existing legal barriers to local entry have been eliminated and the current state of the exchange access market justifies granting ILECs immediate and substantial regulatory flexibility. In particular, GTE explained that Section 251 interconnection requirements and the availability of unbundled elements to supplement competitor's own facilities eliminate an ILEC's ability to exercise market

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these types of problems.

[68] If the Commission decides to adopt an approach that would assign recovery of access costs to a flat rated, per line basis, then it must allow ILECs to assess the charge to customers purchasing unbundled loops.

power in the access market and ensure that new entrants can enter the local market through a variety of means. Accordingly, GTE urged the Commission to rely upon the existence and availability of unbundled elements at cost plus a reasonable profit to constrain access rates.

The record supports the conclusion that Section 251's competitive framework and existing competitive conditions warrant substantially increased regulatory flexibility. *See* Ameritech 32-33; BellSouth 30-31; BA/NY 44; PacTel 19-20; U S WEST 29-30. For example, BA/NY explained that the existence of unbundled elements will "drive down the market price of access services." BA/NY 6. As these carriers observed, "LECs providing access must compete on price not only with alternative providers, but with providers utilizing the LECs' own unbundled facilities, which the competitor combines or rebundles to provide exchange and exchange access services." *Id.* Similarly, Southwestern Bell emphasized that the "direct substitutability" of unbundled elements for ILEC access services creates significant competitive pressure and the opportunity for "access arbitrage." Southwestern Bell 21-22. Quite simply, unbundled elements and other competitive safeguards provided in the 1996 Act, such as the availability of interconnection agreements, serve as an effective constraint on access prices.[69] Consequently, regardless of the state of competition, the new framework created by the 1996 Act justifies substantial deregulation.

Further, the record demonstrates that local and access competition is emerging rapidly as IXCs and CLECs receive state authorizations and negotiate interconnection agreements to provide a wide variety of services.[70] Today, GTE faces competition from 19 competitive networks. Facilities-based competitors are currently collocated in 45 locations in 14 different states with a total capacity of over 8,500 DS1 equivalents.[71] In addition, GTE is currently implementing requests for collocation in an additional 52 offices. PacTel notes that competition has developed in California for both access services and local

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69 Salinger Affidavit at 7.

70 *See* USTA Reply, Atts.7-8 (detailing amount of local and access competition and detailing in-place interconnection agreements).

telephone service through a variety of local switching providers and alternative facilities-based services, and that these competitors offer a "a strong presence of supply alternatives." PacTel 12-14. Likewise, SNET explains that seventeen CLECs, including AT&T, WorldCom, and MCI Metro Access Transmission have been authorized to provide local telephone service in Connecticut and several of these CLECs also "provide switched access services in direct competition with SNET." SNET 13.

The IXCs' arguments that unbundled elements will not restrain pricing because unbundled elements are not presently available in all areas or ILEC control over such elements will lead to anticompetitive behavior, *see, e.g.,* AT&T 44-48; API 8-14; MCI 37-41; CompTel 4-11; Sprint 38, ignore the legal and economic realities of providing service through unbundled elements. As a legal matter, Section 251 and other provisions of the Communications Act ensure that unbundled elements are provided in accordance with appropriate regulatory safeguards and can be used to compete with ILEC services. Thus, AT&T's claims regarding the lack of ubiquitous unbundled elements is without merit because CLECs have a right to request unbundled elements under Section 251(c)(3) anywhere they wish to compete, and Section 252(i) further gives competing providers the right to obtain agreements similar to those already approved by state commissions.[72]

Competitive entry is further protected by state regulatory oversight of ILEC interconnection agreements and the fact that the terms of these agreements must be made available to other carriers. Indeed, the danger is that state-mandated unbundled element rates are so low that they will exacerbate uneconomic arbitrage and deter facilities-based investment – not that they are so high as to constrain the use of unbundled elements. Notwithstanding Congress' desire that such rates result from private negotiations, the implementation of Section 251 by the FCC and many states not only strips the ILECs of any ability to charge excessive rates, but denies them even the opportunity to negotiate fair rates.

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[71] See App. C.

Therefore, contrary to the assertions of AT&T and Sprint, the existing legal framework more than assures the ability of CLECs and IXCs to offer competitive local and access services using unbundled network elements

Nor are the complaints about ILEC control of ordering systems valid. GTE has made available nondiscriminatory access to operational support systems ("OSS"), including ordering, even though it believes the Commission erred in classifying OSS as an unbundled network element. CLECs interconnecting with GTE are able to order unbundled network elements efficiently, without constraints on capacity, using systems equivalent to those GTE employs for retail services.

GTE also sharply disagrees with MCI's and CompTel's characterization of GTE's recent legal challenges.[73] GTE is properly exercising its legal right to ensure that lawful pricing measures are adopted by the Commission and state arbitrators, rather than attempting to obtain a competitive advantage through delay. The simple fact is that the FCC's rules and several state arbitration orders do not allow GTE to recover its lawfully incurred costs and fail to send the proper economic signals contrary to Section 252.

Finally, concerns that ILEC pricing flexibility will lead to predatory pricing or a "price squeeze" are misguided. ILECs are required to provide interconnection and access to unbundled network elements at reasonable rates and under nondiscriminatory terms. Accordingly, the Commission has found that any attempt to evade these requirements would be "relatively easy for [the FCC] and others to detect, and is therefore unlikely to occur."[74] In addition, the Commission has very recently recognized that the ability to offer bundled local access and interexchange services is not inherently anticompetitive and "may be a

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72 *See* 47 U.S.C. §§ 251(c)(3), 252(i).

73 CompTel's argument that access rates cannot be constrained by unbundled elements because they are not a "pure substitute" for switched access services is belied by AT&T's and Time Warner's recognition that such elements are in fact "functionally equivalent" to access. *See* Section II.B.3, *supra.*

74 *See* Consent to Transfer Control of Pacific Telesis Group, FCC 97-28, at ¶ 53 (rel. Jan. 31, 1997).

desirable feature for some customers."[75] Indeed, in rejecting MCI's similar "bundling" arguments in the context of the PacTel/SBC merger, the Commission stated that "MCI and others are also capable of offering one-stop shopping, by building their own local facilities, by reselling unbundled network elements, or by reselling PacTel's facilities and adding that local offering to their existing long distance service."[76] The Commission also soundly rejected MCI's contention that an ILEC could engage in a price squeeze: "As long as the incumbent LEC is required to offer unbundled network elements and resale of retail services, an attempted price squeeze is unlikely to be an effective anti-competitive tool . . . . MCI has not shown . . . that if a price squeeze occurred, it would force one of the long distance carriers and its assets to withdraw from the market."[77] Absent the ability subsequently to recover lost revenues by forcing competitors from the market, any attempt at a price squeeze would be patently irrational.[78]

2. Detailed showings of actual competitive entry are unnecessary given that access customers are large sophisticated telecommunications carriers that can provide access services to themselves.

GTE's opening comments emphasized the importance of allowing ILECs immediate and substantial pricing flexibility absent detailed showings of potential or actual competition. Such flexibility is essential to promoting efficient competitive entry and eliminating years of regulatorily mandated pricing distortions.

As expected, IXCs and competitive access providers ("CAPs") argued for more limited relief, proposing to condition modest degrees of regulatory flexibility on onerous and unreasonable competitive triggers. Ad Hoc 48-49; ALTS 14-17; NCTA 13-17. For example, ACTA suggested that the Commission consider a wide range of economic considerations before allowing ILECs increased flexibility. ACTA 16-

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75 *Id.* ¶ 48.

76 *Id.*

77 *Id.* ¶ 54. *See* Schmalensee & Taylor.

78 *See* Salinger Affidavit at 23-27; Schmalensee & Taylor.

17. Similarly, Ad Hoc stated that ILECs should show that all relevant "geographic" and "functional" markets are subject to actual competition before obtaining pricing flexibility, while leaving the precise contours of this inquiry undefined. Ad Hoc 50-54. In addition, WorldCom proposes that the Commission adopt the factors set forth in the *AT&T Streamlining* proceeding and apply the Herfindahl-Hirschman Index (HHI) to determine whether ILECs should be entitled to increased regulatory flexibility. WorldCom 86.

These proposals are dilatory tactics that would impede progress toward efficiently priced access services and place substantial burdens on the Commission and ILECs. As an initial matter, the Commission must not predicate regulatory flexibility upon demonstrations that both the access services market and the local exchange market are subject to actual, substantial competition.[79] Substantial pricing flexibility would be necessary regardless of the state of competition to promote efficient entry. In the current environment, where competitors can enter the market through a variety of means (and are in fact doing so), such flexibility becomes even more critical.[80]

Further, a market share trigger would place an unduly burdensome factual showing on ILECs, require information that only competitors have, and is not related to the degree of competition in the exchange access market (assuming the degree of competition were even relevant to the need for flexibility). Requiring submission of detailed market share information would create a need for lengthy and complicated market analyses with no offsetting benefits. Moreover, proponents of a detailed economic showing do not demonstrate the significance of local market share to determining the level of competition in the access market. The presence of large, sophisticated access service customers will have a substantial, dampening effect on ILEC access prices irrespective of the incumbent carrier's local (or access) market share. IXCs and other access customers have a strong financial incentive to seek

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[79] *See, e.g.,* TRA 28 ("a market will only be 'substantially competitive' when it is populated with one or more facilities-based providers with one or more independent networks capable of serving the universe of subscribers for the services in question").

competitively priced access services and are fully capable of bypassing ILEC services either through facilities-based competition or unbundled elements if access rates are excessive.[81]

B. Predicating Pricing Flexibility and Price Cap Reform On Detailed Competitive Showings Would Harm Consumers and Competition.

The detailed economic showings sought by AT&T are no doubt intended to delay any meaningful reforms and thereby to restrict ILECs' ability to compete in the access market. Any uncertainty about AT&T's motivation in this regard is dispelled by AT&T's assertion that "it would be premature and irresponsible" to establish any criteria for removing price caps, and its request that the Commission initiate a new proceeding to explore this issue. AT&T 86-87. AT&T has it exactly backwards. Delay would be irresponsible; immediate and substantial deregulation is long overdue, not premature.

Any delay in allowing ILECs to compete effectively will perpetuate existing irrational pricing and deny customers the benefits of meaningful competition. IXCs and CLECs are free to target customers and markets of their choice, raise and lower prices as market conditions warrant, and exit a market if offering service is no longer profitable. ILECs must be given the same degree of flexibility to effectively compete with CLECs and avoid skewing the market for access services. AT&T has cogently detailed the detrimental impact of asymmetric regulation as applied to its own services,[82] confirming that its adherence to a directly opposite position with respect to ILEC access services is opportunistic and has no basis in sound public policy.

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80 Salinger Affidavit at 21.

81 Other ILECs also urge the Commission to reject a detailed, competitive showing prior to receiving regulatory flexibility. Citing numerous problems with market share information, PacTel and U S WEST, for example, emphasize that the existence of negotiated interconnection agreements should justify significant deregulation, including the eventual removal of price cap regulations. PacTel 15-17, 26-28; U S WEST 35-37. Similarly, BA/NYNEX note that market share data is problematic because it is a "backward looking measure that can fail to capture the presence of competitive alternatives." BA/NY 53.

82 *See* Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, 11 FCC Rcd 3271, 3282-85, 3346-47 (1995).

The record underscores the potential for market distortions if ILECs are not given immediate flexibility. BellSouth 30-38; Cincinnati Bell 14-15; SNET 7-10. SNET, for example, urges the Commission to avoid delaying regulatory reforms because access customers are sophisticated and will avail themselves of market opportunities, and established companies are now competing to provide such services. SNET 9-10. Similarly, other ILECs caution that detailed economic showings would impede ILECs' ability to compete when actual competition is already in place and competitors can offer access services through unbundled elements. *See* BellSouth 30-38; BA/NYNEX 44-54; U S WEST 28-34. Rather than requiring detailed competitive justifications, these carriers urge the Commission to give ILECs immediate flexibility when negotiated or arbitrated interconnection agreements are in place. *See, e.g.*, BellSouth 30-31; PacTel 19-20.

Timely ILEC pricing flexibility will allow access charges quickly to reach efficient levels. Ameritech 42-44; SNET 7-8. Such flexibility will further benefit consumers by increasing the range of service offerings, enhancing network efficiency, and lowering network costs. BellSouth 35-36. These benefits will be lost or unduly delayed if, prior to receiving pricing freedom, an ILEC is required to demonstrate to the Commission that some degree of competition exists.

V. A PRESCRIPTIVE APPROACH TO ACCESS REFORM IGNORES MARKET REALITIES AND IS UNNECESSARY.

A. Prescribing Rates or Reinitializing Price Caps Is Fundamentally at Odds With Marketplace Realities.

Not surprisingly, given their desire to constrain ILEC competition to the greatest extent possible, the large IXCs urge the Commission to adopt a "prescriptive" approach to access reform. AT&T 20-29; MCI 20-24; Sprint 49-54. For example, MCI argues that such an approach is "necessary to provide immediate benefits to consumers and stimulate competition in local markets" and is the "quickest and easiest route" to establish reasonable access charges. MCI 6, 9. AT&T asserts that a prescriptive

approach is "the *only* one of the proposed alternatives" to achieve the Commission's goal of moving "access rates toward efficient cost-based competitive levels."[83] AT&T 20. To this end, AT&T proposes to eviscerate the entire price cap structure by "borrowing" state TSLRIC-based unbundled element rates for certain access elements and then "translating" the new cost elements into price cap reductions. AT&T 26-28.

As noted above, any access charge reform approach based on TSLRIC pricing methodologies will result in unlawful rates under Section 201(b), amount to an unconstitutional taking of ILEC property,[84] deter investment, and impede true competition. Rates at these levels also require ILECs to underwrite competitive entry, a wholly uneconomic and unconstitutional result. The Commission must therefore reject AT&T's proposal and any other approach that fails to result in price levels sufficient to recover actual costs plus a reasonable profit. An additional reason for such rejection is that the prescriptive model favored by AT&T, like the other variations proposed in the *NPRM*, would arbitrarily reverse established Commission price cap policies. In instituting its price cap regulatory structure, the Commission dismissed arguments that it should initialize rates through a separate ratemaking proceeding. Rather, the Commission

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[83] In a fit of Orwellian newspeak, AT&T describes the prescriptive approach as a "market" approach. *Id.* at 5. AT&T also contends that the Commission cannot adopt a market-based alternative consistent with the holding of the D.C. Circuit in Farmers Union Central Exchange v. FERC, 734 F.2d 1486 (D.C. Cir. 1984). That case is entirely inapposite. First, in that case, FERC improperly determined that its rate regulation responsibility should protect against only "'egregious exploitation and gross abuse,'" *id.* at 1502; the FCC has not taken any such position here. Second, the *Farmers Union* court criticized FERC for failing to identify any marketplace check that would drive rates into the zone of reasonableness. *Id.* at 1510. Here, the availability of interconnection agreements and unbundled network elements creates exactly such a check. Indeed, the court emphasized that "[m]oving from heavy to lighthanded regulation with the boundaries set by an unchanged statute can, of course, be justified by a showing that under current circumstances the goals and purposes of the statute will be accomplished through substantially less regulatory oversight, so long as the agency adequately assured meaningful enforcement of the public interest standard." *Id.* Here, Congress completely revamped the Communications Act to achieve the quickest possible deregulation, the FCC's authority to pursue market-based solutions cannot be questioned.

[84] If the FCC, nonetheless, were to prescribe rates at TSLRIC it would have to permit ILECs to recover the difference between market rates and rates priced at TSLRIC through the regulatory policy cost

concluded that existing rates should be used to initialize the price cap structure because they were the "most reasonable basis" from which to begin a system of price cap regulation.[85] Neither the *NPRM* nor any commenter has articulated a policy reason that would justify the substantial change wrought by reinitializing price cap rates, and no such reason exists.[86]

Moreover, any prescriptive approach would be inconsistent with the notion of efficient price cap regulation. The existing price cap structure is predicated on the theory that service rates will be driven to appropriate levels by rewarding carriers for investing in efficient technology and reducing costs. Under this model, the benefits of efficient investment are apportioned between carriers and consumers in the form of increased profits coupled with lower subscriber rates. In contrast, a prescriptive approach, whether implemented through rate reinitializations or arbitrary annual productivity increases, would stand the existing price cap structure on its head and eviscerate carrier incentives to invest in new technology. Such actions would also create the specter of future reinitialization that would further destroy efficiency incentives and investment-backed expectations. As a matter of both law and policy, the prescriptive approach must not be pursued.

B. Any Prescriptive Approach Will Be Burdensome and Distort Competition.

In addition to the reasons expressed above, prescriptive approaches should be avoided because they would distort the access market and place substantial burdens on ILECs and regulators. Developing and implementing the necessary cost studies would be a consuming task for all concerned as regulators,

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recovery mechanism to avoid an unconstitutional taking.

[85] *See* Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6814-6817 (1990).

[86] *See* Greater Boston Television Corp. v. FCC, 444 F.2d 841 (D.C. Cir. 1970). *See also* BellSouth 44-49 (noting that the Commission lacks the legal authority to reinitialize price cap indices without first making the express finding that existing charges are unlawful and explaining that any rate prescription efforts would be fraught with both legal and practical problems); *see also* Illinois CC 4, 24 (a prescriptive approach would "launch regulation on the slippery slope of administratively burdensome